Nos. 9781 and 9782

IN THE

United States Circuit Court of Appeals

For the Ninth Circuit

WILSON BROTHERS AND COMPANY (Wilson Bros. & Co.) (a corporation),
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITIONER'S OPENING BRIEF.

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PERNAU-WALSH PRINTING CO., SAN FRANCISCO

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I. THE STATUTORY PROVISIONS FOR JURISDICTION.

These consolidated appeals involve income taxes and delinquency penalties for the taxable years 1932, 1933 and 1934, as follows:

	Tax	Delinquency Penalty	Total
1932	$ 3,316.84	$ 165.84	$ 3,482.72
1933	15,724.73	786.24	16,510.97
1934	11,652.75	582.63	12,235.38
Totals	$30,694.32	$1,534.71	$32,229.07

and are taken from the decisions of the United States Board of Tax Appeals entered August 6, 1940. (R. 68, 231.)

Petitions were filed by Wilson Bros. & Co., the petitioner herein with the United States Board of Tax Appeals in each of the proceedings herein involved within ninety days after the respective deficiency notices were mailed to petitioner (R. 1, 203), viz.: petition in Docket No. 83,397 was filed March 25, 1936, that in Docket No. 93,667 was filed May 21, 1938.

The petitions for review in the two appeals involved were filed with the United States Board of Tax Appeals October 31, 1940 (R. 69, 232), pursuant to the provisions of Sections 1141 and 1142 of the Internal Revenue Code. The two cases were ordered consolidated by this Court for purposes of record, briefing, hearing and decision (R. 195, 250) with a complete transcript of the record to be filed only in case No. 9781, which of itself only concerns the taxable year 1934. Therefore to be included in the decision by this Court will be case No. 9782 which is printed in skeleton form in the Transcript (R. 195) and which includes the taxable years 1932 and 1933.

Orders enlarging time within which to transmit, prepare and file the records on appeal in the two cases were duly made by this Court and transmitted to the United States Board of Tax Appeals.

Petitioner is a corporation organized under the laws of the State of Nevada, having, during the taxable years involved, its offices in the City of Reno, Nevada, and the City and County of San Francisco, California (R. 33), and filed its income tax returns for all years involved with the Collector of Internal Revenue, First California District.

II. STATEMENT OF THE CASES.

The petitions involved apply only to such parts of the decisions rendered as are covered by the hereinafter numbered issues stated in the memorandum report or opinion of the United States Board of Tax Appeals, viz.: III(a) and (c) (R. 37, 40), IV(a) (R. 41), V (R. 54) and VI (R. 67). These bring before the Court the following questions: (1) The right of petitioner to deduct amounts charged off as partial bad debts and deducted for the year 1934; (2) The right of petitioner to deduction of additional depreciation on the steamship "Idaho" for all three years; (3) Whether petitioner is liable under section 104 of the Revenue Act of 1932 and section 102 of the Revenue Act of 1934 for surtax for accumulation of surplus; (4) Whether petitioner is liable for a five per cent negligence penalty for each of the three years under section 293(a) of the Revenue Acts of 1932 and 1934, and (5) Whether the Board by subdividing its findings of fact to apply to separated issues and not having general findings of fact which would apply to all issues to which they were material did not grossly err in its decisions. To the foregoing questions the following statement of material facts will be confined.

III. STATEMENT OF FACTS.

1. Prior to the organization of petitioner and on January 31, 1927, F. A. Wilson and W. T. Wilson formed a copartnership to engage in the lumber and shipping business under the name of Wilson Bros. &

Co., which continued to do business under that name until after the formation of the petitioner corporation with the same name, when said copartnership was dissolved in January, 1929. (R. 23, 33.) The two brothers had been continuously and actively engaged in the lumber business since 1906. (R. 88.)

2. Petitioner, Wilson Bros. & Co. (erroneously entitled as Wilson Brothers and Company in the deficiency notices in the proceedings involved (R. 32) is a corporation organized under the laws of the State of Nevada, December 14, 1928, with office in Reno, Nevada, and its principal office in San Francisco, California, during the taxable years involved. The corporation was organized by F. A. Wilson and W. T. Wilson, brothers and partners in the above-described partnership, with an authorized capital stock of 200,000 shares of a par value of $25.00 per share to take over and continue the business of said copartnership. Each of the brothers purchased 20 shares of said capital stock, each paid the petitioner $500.00 therefor, and no other shares have ever been issued. (R. 24, 33.)

3. During the taxable years petitioner kept its books of account on the accrual system and filed income tax returns with the Collector of Internal Revenue for the First District of California. (R. 33, 89.)

4. Petitioner corporation was organized to take over the business of the copartnership, to acquire, own and operate timber lands, to engage in the logging business, the manufacture and transportation of lumber, the operation of steamships as a part of the

logging and lumber business, the buying and selling of lumber, and engaging in the general lumber business. (R. 35, 36, 55, 60, 88.)

5. There was never any intention on the part of the two stockholders that the corporation was to be organized as a holding investment company (R. 55, 60) or that it was to be availed of for the accumulation of surplus or avoidance of surtax on the shareholders. There was never any discussion between or decision by the two stockholders concerning any element of taxation as a reason for forming the corporation or its subsequent failure to pay dividends during the years from its formation through the taxable years involved. (R. 88, 103.)

6. When the corporation was formed the inflated prosperity of late 1928 and early 1929 held sway and petitioner's stockholders had great expectations for petitioner's future. By July of 1929 the impending crash of October, 1929, had so effected the lumber industry that petitioner was forced to "lay up" the three steamships which it operated because their operation ceased to be profitable. (R. 60, 94, 100.) However, at no time from the formation of the corporation through the taxable years involved did the stockholders abandon their plan to enlarge petitioner's business by engaging in logging, lumbering, and shipping, which required larger capital than that represented by the net assets of petitioner. (R. 35, 36, 100-103.)

7. The books of account of petitioner were kept on a simple basis and consisted of journal, ledger, sales books and bank books. Instead of a cash book, bills

were sent out in duplicate and, when a customer paid, one of the copies was kept by petitioner as a record of payment. Such payments were entered in the ledger and the payment was deposited in bank. This system of accounting sufficiently reflected the business transactions of the corporation to the satisfaction of the stockholders. (R. 89, 117.) In the balance sheets made up by the corporation, including those in the income tax returns for the taxable years involved, the cash on hand was incorrectly overstated and did not correspond with the cash position shown in the ledger for the years involved. (R. 90.) These differences between the amounts shown in the ledger and in the balance sheets, including those shown in the returns, arose from a peculiar custom of the two stockholding brothers. From year to year each of the brothers without any consideration whatsoever therefor would place in the cash box of the corporation an I.O.U. for considerable and equal amounts and which they considered the equivalent of cash and called "cash". Those I.O.U.'s did not represent any money borrowed from the corporation and the purpose of putting them into the cash box was to stimulate the brothers to pay them up and produce "a good sized corporation" and at the same time to show (to themselves) large assets. From time to time each of the brothers made contributions on the I.O.U's. Such contributions were deposited in bank and the amounts were then entered in the corporation's books. The existing I.O.U.'s were then destroyed and new ones for smaller amounts were inserted in their place. Such strange custom threw the books of account out of balance with the cash

position shown on the trial balances on the income tax returns and incorrectly indicated a large capital or paid-in surplus in the hands of the corporation. The misstatement of the cash position in the income tax returns did not affect petitioner's taxable income or earned surplus for the years involved in these cases. (R. 91, 117.)

8. When the above-mentioned partnership was dissolved after the organization of petitioner corporation, the partners transferred all their interests in the partnership, excepting accounts receivable and payable, to petitioner. In addition, and over and above the $1000.00 subscribed for shares of stock, the two stockholders contributed assets consisting of cash, stocks in domestic corporations, interests in steamships, land buildings and furniture and fixtures, which, with certain gifts to the corporation by their mother (R. 27, 30, 93) had a book value of $696,000.00. (R. 181, Schedule K, Respondent's Exhibit A.) The cash contributed was, with the exception of a small amount required for operating expenses, used for the purchase of securities.

9. The contributions in cash after the organization of the corporation and down through the years herein involved, were made in equal amounts by each of the stockholders as follows: During the latter part of 1929, $50,000.00; during January, 1930, $54,000.00; and during 1931, $480,312.24, which the brothers had on deposit in the San Francisco Bank. (R. 58, 62, 109.)

10. On the organization of petitioner corporation Mary H. Wilson, the mother of F. A. Wilson and

W. T. Wilson, donated to the corporation, without any consideration to her, a 55/100ths interest in the steamship "Idaho" (R. 27, 43) and also a 10/32nds interest in the steamship "Oregon". (R. 30, 45.) Both of said donations were made on January 2, 1929. Each of F. A. Wilson and W. T. Wilson individually owned a 10/100ths interest in the steamship "Idaho" and an 11/32nds interest in the steamship "Oregon" which had not formed a part of the partnership assets but were contributed by them to petitioner on January 2, 1929. (R. 93.) The value of these steamship interests was set up on the books of the corporation at $175,000.00. (R. 181.)

11. The history of the steamship "Idaho", until the interests of Mary H. Wilson, F. A. Wilson and W. T. Wilson passed to the petitioner corporation on January 2, 1929, is set forth in paragraph 13 of the Stipulations of Facts (R. 26) and is of importance because of the issue relating to the proper amount of depreciation to be allowed petitioner on the vessel. When on February 16, 1917, Henry Wilson, husband of Mary H. Wilson and father of F. A. Wilson and W. T. Wilson, gave his wife a 20/100ths interest in the steamship and each of his sons a 5/100ths interest, the steamship had a fair market value of $395,000.00. (16 B. T. A. 1284, Memorandum Opinion in these proceedings, R. 48.) In 1917 the fair market value of a fractional interest in a vessel was its proportionate part of that of the total value. (R. 48, 106.)

12. In addition to owning the steamship interests mentioned above, petitioner managed and was disburs-

ing and collection agent for the steamship "Svea". (R. 38, 39.)

13. During the taxable years involved petitioner carried on and conducted its lumber business to such extent as could be done under the conditions resulting from the economic and financial depression existing during said years. (R. 56, 88, 102.)

14. Petitioner corporation declared no dividends during the taxable years 1932, 1933 and 1934 herein involved because the profits of the petitioner were not believed to be sufficient to warrant dividends, were desired for future expansion purposes, and the value of its assets, as compared with the costs thereof, were impaired. (R. 101.) The failure to declare dividends was not because of a plan by the brothers to avoid individual taxes. (R. 103.) The two stockholders and officers of the corporation, F. A. Wilson, president, and W. T. Wilson, secretary-treasurer, drew no salaries, for the same reasons they did not have petitioner pay dividends. (R. 61.)

15. The assets and particularly the securities were being conserved because the two stockholders had never abandoned their original idea of enlarging the business by re-entering the logging, lumbering and milling business, which according to their estimate would require fully a million and a half dollars. (R. 101, 102.) The securities were acquired and held by the corporation in order to have liquid assets which would enable them to raise cash quickly and buy anything the stockholders selected for the enlargement of their business. (R. 102.)

16. During the year 1934 petitioner claimed certain deductions for partially worthless debts, which it charged off on the direct write-off method in the total of $15,144.40, as follows:

Woodhead Lumber Company of California	$5,000.00
Steamship "Svea"	4,644.40
Kentucky Fuel and Gas Corporation bonds	5,500.00

These deductions were denied in part III of the memorandum opinion. (R. 32, 37, 94.)

(a) The partial write-off and claimed deduction of $5000.00 as a partially worthless bad debt of the Woodhead Lumber Company of California resulted after the corporation had transferred its going business to another corporation and had remaining assets of such dubious character and value that, after investigation made by the Secretary-Treasurer of petitioner, it was determined that at least $5000.00 of the debt owing petitioner could not be recovered. (R. 95.)

(b) In 1933 petitioner wrote off as a partial bad debt owing from the owners of the wooden steamship "Svea" the amount of $2160.80 and in 1934 it similarly wrote off the amount of $4644.40, which amounts were claimed respectively as deductions in petition's returns for the years mentioned. The petitioner owned no interest in the "Svea" but was managing, disbursing and collection agent therefor. On January 1, 1933, accounts receivable from the "Svea" amounted to $9081.78 and on January 1, 1934, to $10,804.01. The vessel was owned by many small owners who expected petitioner to make the necessary advances to keep the boat in condition to be main-

tained in condition, which it was bound to do and did. Petitioner could anticipate repayment only from earning or recovery from the many owners. As the vessel had not been operated for several years there were no earnings from which to recoup and in 1933 their attorney advised them that a suit to recover would be inadvisable, while in 1934 it appeared that the vessel could not be placed in operation for some time. (R. 38.)

(N. B. While petitioner admits that the accounts receivable from the "Svea" were not proven deductible for normal income tax purposes it will later contend that such accounts must be reduced by their actual value in determining the amount of petitioner's earned surplus and annual earnings available for dividends.)

(c) On January 1, 1934, petitioner was the owner of first lien s.f. 6½ A Bonds of the Kentucky Fuel and Gas Corporation due 1942, having a par value of $43,000.00 acquired as follows:

$18,000.00	par value acquired before January 1, 1932 at a cost of	$9,000.00
$15,000.00	par value acquired during the year 1932 at a cost of	450.00
$10,000.00	par value acquired during the year 1933 at a cost of	20.00
$43,000.00	total par value having a cost on January 1, 1934, of	$9,470.00

(R. 127, 170.) On December 31, 1934, when the petitioner wrote off the amount of $5500.00 as a partially bad debt on account of said bonds and thereafter

claimed that amount as a deduction in its income tax return for the year 1934, the market quotations on the basis of a $100.00 bond as of December 31, 1934, show $4.50 bid and $6.00 asked. (R. 128.) At that time the company was in receivership and it appeared that petitioner would at least take a loss in the amount charged-off. (R. 96.) At December 31, 1934 on "bid basis", the bonds were worth only $1935.00 and on an "asked" basis they were worth $2580.00, while, on the value for partial deduction taken by petitioner there remained as an asset value for said bonds the amount of $3970.00, which was in excess of both the "bid" and "asked" valuations.

17. During the taxable years involved, for which the Board of Tax Appeals held that petitioner was availed of for the purpose of preventing imposition of surtax upon its shareholders (R. 67), W. T. Wilson paid about $150.00 Federal income tax in 1932 and none in 1933 and 1934, while F. A. Wilson, the other stockholder, paid no tax for any of the three years. (R. 59.)

IV. SPECIFICATION OF ERRORS RELIED UPON.

Errors are specified in abbreviated form in the order in which they were assigned in the petitions for review of the two proceedings before the United States Board of Tax Appeals (R. 69, 232) and are arranged to cover in one statement the errors alleged to warrant review and partial reversal of the decisions of the Board based upon the consolidated re-

port or memorandum opinion of the Board (R. 31) for the three taxable years involved, viz.:

1. The Board erred in failing to find and determine that the $43,276.06 account receivable due from the Woodhead Lumber Co. of California was impaired during the year 1934 in the amount of $5000.00, as charged off and deducted by petitioner for said year as a partial bad debt, and that petitioner was entitled to a deduction for said year of said $5000.00. (R. 73, 237.)

2. The Board erred in failing to find and determine that the cost of bonds of the Kentucky Fuel Gas Corporation owned by petitioner was impaired in value during the year 1934 in the amount of $5500.00, as charged off and deducted by petitioner for said year as a partial bad debt, and that petitioner was entitled to a deduction for said year of said amount of $5500.00. (R. 74, 237.)

3. The Board erred in failing to find and determine that petitioner was entitled to deduct for each of the three taxable years involved the amount of $6100.77 per annum for depreciation on the steamship "Idaho" and to allow a value as a basis of depreciation from January 1, 1932, in the amount of $91,337.78. It further erred in failing to allow petitioner, as a part of the basis of depreciation of said steamship "Idaho" from January 1, 1932, the amount of $79,000.00 as the fair market value of a twenty per cent interest therein given to Mary H. Wilson on February 6, 1917, by her husband, when said steamship had a total fair market value of

$395,000.00, which said twenty per cent interest was donated to petitioner by said Mary H. Wilson on January 2, 1929. (R. 75, 238.)

4. The Board erred in finding and determining with respect to all of the taxable years involved and without discrimination or distinction between and contrary to the circumstances and facts relating to the several years 1932, 1933 and 1934 that petitioner was availed of in each of said taxable years for the purpose of preventing imposition of surtax upon its shareholders through the medium of permitting its gains and profits to accumulate instead of being divided or distributed. The Board erred in determining that for the taxable years 1932 and 1933 petitioner was liable for the respective amounts of $3316.84 and $14,224.80 as surtaxes for the alleged accumulation of surplus during each of said years contrary to the provisions of section 104(a) of the Revenue Act of 1932. It further erred in determining that for the taxable year 1934 petitioner was liable for the amount of $9740.70 as a surtax for the alleged accumulation of surplus contrary to the provisions of section 102(a) of the Revenue Act of 1934. (R. 75, 76, 239, 240.)

5. The Board erred in finding and determining that for each of the taxable years involved petitioner was liable for a five percentum negligence penalty under section 293(a) of the Revenue Acts of 1932 and 1934. (R. 77, 240.)

6. The Board erred in not making its findings of fact comprehensive and general so that, where

material, they would apply equally to and be adequate for the proper determination of all the issues involved. The Board further erred in separating and severing its findings of fact under separate and independent issues in its report or memorandum opinion and thus making facts of material general import applicable only to one issue when they should have been made applicable to other issues to which they were also material. (R. 78, 241.)

7. The Board erred in intermingling findings of facts, conclusions of fact and conclusions of law in the several subdivisions of its report or memorandum opinion so as to render the decisions based thereon arbitrary and erroneous in law and fact. (R. 79, 242.)

8. The Board erred in not making its findings of fact and conclusions of law conform to the evidence. (R. 79, 242.)

V. ARGUMENT OF THE CASES.

1. THE BOARD ERRED IN DETERMINING THAT PETITIONER WAS NOT ENTITLED TO DEDUCT FROM THE ACCOUNT RECEIVABLE DUE IT FROM THE WOODHEAD LUMBER CO. OF CALIFORNIA THE AMOUNT OF $5000.00 AS A PARTIAL BAD DEBT WHICH IT HAD WRITTEN OFF AND DEDUCTED FOR THE TAXABLE YEAR 1934.

The partial write off made and deduction claimed against the Woodhead Lumber Co. of California in the amount $5000.00 for the year 1934 was disposed of in the deficiency notice by the following explanation:-

> "2. The bad debts have been disallowed in accordance with section 23(k) of the Revenue

> Act of 1934 for the reason no evidence has been submitted to establish the worthlessness thereof and no permission has been granted you to change from the actual bad debt basis elected in prior years to the reserve basis." (R. 17.)

The second clause of the explanation refers to respondent's claim that the partial deduction was not a write-off but a transfer to a reserve for bad debts, which transfer could not be made without permission granted by the Commissioner. (Regulations 86, Art. 23(k)-1-(2).) However, this part of respondent's explanation and claim is entirely erased by the report or memorandum opinion of the Board wherein it is found that: "The petitioner was on the actual charge-off method of deducting bad debts" (R. 37), and consequently did not use the method of transfer to reserves for bad debts.

Section 23(k) of the Revenue Act of 1934 which relates to the deduction from gross income of bad debts, reads as follows:

> "(k) *Bad Debts*—Debts ascentained to be worthless and charged off in the taxable year * * *; and when satisfied that a debt is recoverable only in part, the Commissioner may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction."

The allowance by the Commissioner of the partial deduction of a bad debt is to be found in Regulations 86, Art. 23(k)-1-(2) where it is provided.:

> "If all the surrounding and attending circumstances indicate that a debt is worthless,

> either wholly or *in part, the amount which is worthless and is charged off* or written down to a nominal amount on the books of the taxpayer *shall be allowed* as a deduction in computing net income." (Italics supplied.)

With regard to the deduction of $5000.00 as a partially worthless debt of the Woodhead Lumber Co. of California, it may be said that that part of the report or memorandum opinion which refers thereto (R. 37, 38) is confused, incorrect, and erroneous. The uncontradicted facts which show this follow.

On January 1, 1934, and throughout that year, petitioner had accounts receivable from the Woodhead Lumber Co. of California amounting to $43,276.06. On December 31, 1934, petitioner wrote-off $5000.00 of the total accounts receivable from that company as a partial loss and in its income tax return for 1934 deducted that amount from its gross income as a partial bad debt. (R. 37.)

In 1932 the Woodhead Lumber Co. of Nevada bought the inventory and some of the physical assets of the Woodhead Lumber Co. of California in consideration of its promissory note for $25,000.00 and, as collateral, $37,000.00 par value of its capital stock. The California corporation turned over to petitioner as security for its indebtedness of $43,276.06 the note for $25,000.00, secured by $37,000.00 par value stock of the Nevada corporation, which stock petitioner did not believe to have a value of $37,000.00. (R. 38, 39.) The face value of the $25,000.00 note only may be considered as the maximum value of the pledge.

During 1934 the secretary-treasurer of petitioner went to Los Angeles and went over the books and affairs of the Woodhead Lumber Co. of California to ascertain its financial condition. He found that books of the company disclosed that "it was in very bad shape"; that there was a heavy mortgage on the assets; that there was a bond issue of about $200,000.00 on a specific piece of land and that the bonds and interest rights preceded those of general creditors, of which petitioner was one; that the improvements and lumber business of the corporation were located on rental property which was held on a month to month basis and that if the corporation was thrown off that property the improvements thereon would become practically worthless; and that the balance of the assets of the corporation consisted of accounts receivable which he judged "were no good". After careful examination of the books of the California corporation, the secretary-treasurer of petitioner determined that with the best advantage to that corporation, petitioner would lose at least $5000.00 and therefore wrote that amount off the corporation's books in 1934 as being a reasonable deduction for partial loss. Petitioner never recovered the $5000.00 which it deducted, and the affairs of the Woodhead Lumber Co. of California continued to grow steadily worse. (R. 95.)

The foregoing supplies the evidence of partial worthlessness which respondent apparently lacked or never sought when he made his explanation of reasons for denying the deduction. (*Supra.*) Other than that statement in the deficiency notice, there is

no plea or proof of defense of respondent's denial of the deduction.

Conceding that the promissory note of the Nevada corporation which had been turned over to petitioner by the California corporation as security was worth its face value, the status of the account receivable of petitioner from the California corporation in 1934 was as follows:

Accounts receivable, Woodhead Lumber Co. of California	$43,276.06
Unpaid promissory note for $25,000.00 as security	25,000.00
Balance due petitioner, unsecured	$18,276.06

With the California corporation shown by the uncontroverted evidence recited above to be in a hopeless financial condition, the deduction of $5000.00, less one-third of the $18,276.06, may not be deemed to be an unreasonable write-off and deduction for a partially worthless bad debt. Petitioner has made proof of the "surrounding and attending circumstances" which indicated that the debt of the Woodhead Lumber Co. of California was partially worthless within the intendment of Regulations 86, Art. 23(k)-1-(2) (*supra*) and respondent did not introduce a single item of evidence to prove the contrary. All that respondent did was to attempt to confuse the issues by injecting the dealings of petitioner with the Woodhead Lumber Co. of Nevada. Over this confusion the deciding member of the Board of Tax Appeals seems to have stumbled and made his erroneous decision.

Under part III(a) of the report or memorandum opinion, the Board (R. 37) apparently finds that

there were two deductions sought on the accounts receivable from the Woodhead Lumber Co. of California: (1) $15,144.40 and (2) $5000.00. This is a confusion, for only $5000.00 was sought as a deduction. (R. 95.) It is next found that petitioner was on the actual charge-off method instead of the reserve method of deducting bad debts. (R. 37.) These determinations entirely defeat the Commissioner's reasons set forth in the deficiency notice (*supra*) for disallowing the deductions.

The next finding is that petitioner caused an examination of the affairs of the Woodhead Lumber Co. of California and from resulting disclosures reached the conclusion in 1934 that $5000.00 would be a reasonable amount to write-off and take as a deduction for such alleged partial debt during the year 1934 and such was taken. (R. 37.) There is no finding that the examination made by petitioner was superficial, or that the conclusion reached was unsound, or that the conclusion was not supported and sustained by the examination. (R. 37.) Under such conditions and upon such findings petitioner was entitled to the naturally consequent finding that the $5000.00 was deductible.

Moock Electric Supply Co. v. Commissioner,
41 B. T. A. 1209, 1211.

The findings and conclusions then fall into the confusion raised by respondent at the trial as a smoke-screen of defense. Apparently on the sole ground that petitioner was doing business with the Woodhead Lumber Company of Nevada it is found that the worthlessness of the debt of the Woodhead Lumber

Co. of California, an entirely different entity, has not been shown. (R. 38.) The worthlessness of the debt of the California corporation is a matter separate, its solvency is something apart, and the Board erred in considering anything concerning the Nevada corporation in denying the deduction to petitioner.

The finding and determination of the Board on this issue is not supported by the facts and is clearly erroneous. As stated in *Clark v. Commissioner,* 85 Fed. (2d) 622, 624, (C. C. A. 3.)

> "A taxpayer is expected to be reasonable and honest, but the taxing act does not require him to be an incorrigible optimist; * * * neither should he be 'unduly pessimistic' when claiming deductions for bad debts. He 'must make a reasonable investigation of the facts and draw a reasonable inference from the information thus obtainable'."

The facts show that the petitioner met every requirement of his rule and the determination of the Commissioner and the re-determination of the Board should be reversed.

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2. THE BOARD ERRED IN DETERMINING THAT PETITIONER WAS NOT ENTITLED TO DEDUCT THE AMOUNT OF $5500.00 AS A PARTIAL LOSS OR BAD DEBT RESULTING FROM DEPRECIATION IN VALUE OF BONDS OF THE KENTUCKY FUEL GAS CORPORATION OWNED BY PETITIONER AND WHICH IT HAD WRITTEN OFF AND DEDUCTED FOR THE TAXABLE YEAR 1934.

The explanation for the denial of the deduction found in the deficiency notice and the statutory and regulation provisions applicable are quoted at the

opening of the argument on the preceding point, and will not be repeated.

The gist of the denial of the deduction found in the memorandum opinion of the Board (R. 41) is stated as follows:

> "The record does not show when or from whom the bonds were acquired, the cost, nor whether in 1934 there was a basis for partial charge-off which did not exist in 1933 or earlier."

This premise for affirmation of the Commissioner's denial of the deduction is in part erroneous and in part immaterial assumption. (a) The record does show "when" the bonds were acquired as far as necessary for the purpose of partial deduction: viz. $18,000.00 par value bonds were acquired before January 1, 1932; during 1932 $15,000.00 par value bonds were acquired, and during 1933 $10,000.00 par value bonds were acquired. All that is material as to date of acquisition, viz.: acquisition before 1934, is shown in the record. (R. 127, 170.)

(b) "From whom the bonds were acquired" is entirely immaterial. Such information would not and could not in any way affect the cost, 1934 worth, or depreciated value of the bonds.

(c) "The cost" of the bonds is shown by the record (R. 127) at a total of $9470.00.

(d) "Whether in 1934 there was a basis for partial charge-off which did not exist in 1933 or earlier" is not material to the allowance of a partial charge-off and deduction in 1934. The uncollectible portion of a debt not wholly worthless may be charged off at any

time. The rule which is applicable to a total charge-off and deduction does not apply to a partial write-off and deduction.

Moock Electric Supply Co. v. Commissioner, 1209, 1211.

To close its argument to deny the partial deduction by petitioner on the partial worthlessness of the Kentucky Fuel Gas Corporation bonds in 1934 and to sustain the Commissioner the memorandum opinion cites the bid prices on the bond for only a portion of the years from January 1, 1930 to December 31, 1934, using a fragment of the evidence and ignoring the remainder to bolster its conclusion that there was no error. (R. 41.)

The market values of the bonds were taken from the Bank and Quotation Record (R. 128) and were as follows:

	Bid	Asked
January 1, 1930	$74.00	$79.00
December 31, 1930	35.00	45.00
December 31, 1931	5.00	7.00
December 31, 1932	1.25	4.00
December 31, 1933	2.00	4.00
December 31, 1934	4.50	6.00
December 31, 1935	8.00	
December 31, 1936	18.50	
November 30, 1937	8.00	

When we subtract the bid figures for any of the years from the cost of the bonds to the petitioner we find in each year a balance in excess of the partial deduction sought by petitioner. How then may the Board select any one year, particularly the year 1934, and

determine which year was the proper one in which to take a partial deduction, or to say that 1934 was not the proper year.

This decision of the Board was made despite prior declarations by it of the rights of a taxpayer, viz.:

> "The ascertainment, under the statute, of partial or (total) worthlessness of a debt *is obviously for the petitioner, in the exercise of his best judgment,* first to make. *Dillon Supply Co.,* 20 B. T. A. 404, 409. The facts and circumstances surrounding the petitioner's decision should establish it as that of a prudent person of sound judgment. *Anna Bissell,* 23 B. T. A. 572, 578." (Italics in text supplied.)
>
> *Henry A. Hunting v. Commissioner,* 32 B. T. A. 495, 500.

Furthermore, the finding of no proof was made in the face of uncontradicted testimony of the secretary-treasurer of the corporation that "We made the charge-off because the company went into a receivership and we would not recover the full amount but would take a loss in the amount charged off. I made an investigation through the people who issued the bonds and that was their opinion. I had a list of the assets and liabilities of the corporation and in studying the balance sheet it appeared that 'there (were) certain assets that were O. K. and that there would be some recovery due to that fact.' I discussed the matter with my brother, the other stockholder in the corporation, and we reached the determination that the situation of the Kentucky Fuel & Gas Corporation looked pretty bad and that the amount of

$5500.00 should be written off as there was no way to set it back." (R. 96.)

The foregoing quotation from the record, which was not disputed or overcome by any evidence offered by respondent, clearly shows that petitioner complied with the rule adopted by the Board and cited in *Hunting v. Commissioner, supra.*

The only real attempt of respondent to overcome the position assumed by petitioner in deducting the $5500.00 on account of the partial worthlessness of the first sinking fund 6½% bonds of 1942 of the Kentucky Fuel Gas Corporation bonds which petitioner owned, was to bring out on cross examination the bid and asked prices on the corporation's debentures 6½s of 1938, an entirely different security from that owned by petitioner. (R. 129.) If this testimony is relative or material to the issue involved, it certainly confirms the judgement of petitioner's officers in determining to make the partial write-off and deduction, because it shows a static condition for 1932, 1933 and 1934 of nothing bid and $2.00 asked for such securities.

An accountant testifying for the petitioner stated that in his opinion that a substantial loss of value of the bonds had occurred. Also, that because the bonds owned by petitioner were the senior issue and contained a sinking fund provision, the market quotations were a very definite index of the extent of the impairment of actual value, that is, the amount collectible on such bonds. He further testified that good accounting practice required the write-off of the cost

of these bonds by at least the amount of $5500.00 claimed as a deduction. (R. 127-128.)

It appears that the memorandum opinion (R. 41) apparently assumes that a further downward change in market value of the bonds was necessary in 1934 in order to warrant the partial write-off and deduction. This assumption is contrary to the rule applicable to partial deductions as adopted by the Board and the courts, viz.:

> "And nothing seems to be better settled than the partial worthlessness, as distinguished from total uncollectibility, is a ground for deduction which may be pursued or relinquished by a taxpayer *entirely* at his option. If he fails to take a deduction for partial worthlessness in any year, *it does not have the effect of foreclosing him from a reliance upon different developments at another time. Blair v. Commissioner,* 91 Fed. (2d) 992 (C. C. A. 2d Cir.); See *American Cigarette & Cigar Co. v. Bowers,* 92 Fed. (2d) 596 (C. C. A. 2nd Cir.); *Freeman-Dent-Sullivan Co. v. United States,* 21 Fed. Supp. 972; G. C. M. 18525, 1937-1 C. B. 80, 82." (Italics in text supplied.)
>
> *Moock Electric Supply Co. v. Commissioner,* 41 B. T. A. 1209, 1211.

In view of the foregoing it is respectfully submitted that part III(c) of the report or memorandum opinion of the Board is subject to unqualified reversal.

3. THE BOARD ERRED IN FAILING TO FIND AND DETERMINE THAT PETITIONER WAS ENTITLED TO DEDUCT FOR EACH OF THE THREE TAXABLE YEARS INVOLVED THE AMOUNT OF $6100.77 PER ANNUM FOR DEPRECIATION ON THE STEAMSHIP "IDAHO" AND TO ALLOW A VALUE AS A BASIS OF DEPRECIATION FROM JANUARY 1, 1932, IN THE AMOUNT OF $91,337.78.

This issue involves part IV of the report or memorandum opinion of the Board of Tax Appeals (R. 41) and involves but a single question of law. The Board held that the basis of petitioner's 75% interest in the Steamship Idaho, acquired by tranfers to it in 1929 was to be determined for purposes of depreciation as follows:

10/100ths transferred by F. A. and W. T. Wilson...	$ 39,500.00
10/100ths purchased by above brothers and transferred to petitioner	11,716.67
35/100ths transferred by Mary H. Wilson.....	70,000.00
20/100ths transferred by Mary H. Wilson.....	40,000.00
Giving petitioner a total basis (unadjusted) of.....	$161,216.67

The Board further held that the adjustment for depreciation allowed or allowable, with respect to the foregoing interests, was $108,750.00, resulting in an adjusted basis on January 1, 1932 of $52,466.67. (R. 47-51.) As petitioner is in accord with the Board's determination on this issue in all respects, except as to the basis applicable to the 20/100ths interest acquired by Mary H. Wilson as a gift from her husband February 16, 1917, and transferred by her to petitioner in January, 1929, detailed facts applicable to the other interests will be omitted.

The parties are in agreement that the adjusted basis as of January 1, 1932 is subject to a depreciation

allowance of 6⅔%, on a fifteen year remaining useful life. The Board's figures, *supra,* result in an annual allowance of $3497.77 as compared to petitioner's present claim (less than claimed before the Board) of $6097.77.

The dispute as to the basis of the 20/100ths interest transferred by Mary H. Wilson to Petitioner in 1929 is dependent upon the effect to be accorded Section 113 of the Revenue Act of 1928. The facts applicable to the question are stated briefly:

On February 6, 1917, Mary H. Wilson was given a 20/100ths interest in the "Idaho". This interest had a cost of $40,000.00 but on that date had an admitted fair market value of $79,000.00. (R. 48-50.) On January 2, 1929, she contributed this interest to petitioner. Respondent claims the basis to petitioner to be the cost to Mary H. Wilson's donor, or $40,000.00. Petitioner claims the basis to be market value as of February 6, 1917, or $79,000.00. (R. 47-50.)

The Board erroneously quotes and relies solely upon section 113(a)(2) of the Revenue Act of 1932 in making its determination upon this point. (R. 50.) As the transfer was made by Mary H. Wilson in January, 1929, the Revenue Act of 1932 has no application. However, the Revenue Act of 1928, provides the applicable statutory provisions and from that we quote.

Section 113(a)(2) of the Revenue Act of 1928 provides:

> "If the property was acquired by gift after December 31, 1920, the basis shall be the same as

it would be in the hands of the donor or the last preceding owner by whom it was not acquired by gifts. * * *"

Section 113(a)(4) of the Revenue Act of 1928, which is highly important and which the Board entirely ignores, reads, as far as material, as follows:

"If the property was acquired *by gift* or transfer in trust *before December 31, 1920, the basis shall be the fair market value of such property at the time of such acquisition.*" (Italics supplied.)

These subsections find their inception in Section 202(a) of the Revenue Act of 1921, which Section, in so far as material, provides:

"(2) In the case of such property acquired by gift after December 31, 1920, the basis shall be the same as that which it would have in the hands of the donor or the last preceding owner by whom it was not acquired by gift. * * *"

* * * * * * *

"In the case of such property acquired by gift *on or before December 31, 1920, the basis* * * * *shall be the fair market value* of such property at the time of such acquisition." (Italics supplied.)

The second paragraph of the quotations from section 202 (a)(2) was put into the act to specify existing law. *Seideman's Legislative History,* 784, 785. Therefore the basis of the 20/100ths interest of the Idaho, from February 6, 1917 until Mary H. Wilson parted with it was clearly its value on February 6, 1917, i.e., $79,000.00.

Section 202(a)(2) of the Revenue Act of 1921 was adopted in order to prevent tax evasion. The evasion in question was the result of a simple expedient. A man who had property with a low basis to himself would not sell it when its value was high, he would give it to his wife and she would sell the property. If he had sold it he would have been taxed with the gain. Because the wife's gain was only the difference between the value at the time of the gift and what she received on the sale (practically no difference) and the transaction escaped tax.

Seideman's Legislative History, 784, 785.

The purpose of the amendment was to prevent future evasion. An unsuccessful attempt was made to make the rule retroactive to all gifts after February 28, 1913. The amendment as adopted left the basis of property in the hands of existing donees exactly as it had been before, and did so deliberately.

Seideman's Legislative History, 785.

With this legislative history and purpose in mind it becomes pertinent to consider the language of Section 113(a)(2) of the Revenue Act of 1928, quoted *supra.* The section provides that the basis "shall be the same as it would be in the hands of the *donor or the last preceding owner by whom it was not acquired by gift.*"

If this section ended with the word donor, petitioner's contention would clearly be correct, without consideration of section 113 (a) (4). If it did not contain the words "the donor" respondent's interpretation would have to be sustained, if section

113(a)(4) could be discarded. But the statute actually contains both expressions, and it must be assumed that their inclusion was deliberate rather than accidental, particularly in view of the expressed purpose of the amendment.

If Congress meant that in all cases the basis would be the same as that of the last preceding owner by whom it was not acquired by gift it would have left out the words "the donor" and the congressional intent would be explicit in the language. What was very definitely intended was that the basis of future gifts would not be changed by the making of the gift. It intended only a prospective application of the amendment, not a retrospective application that would change the existing basis.

The addition of the last paragraph in section 202(a)(2) quoted above and its perpetuation in section 113(a)(4) quoted above (which the Board has completely ignored), proves the argument made above.

The absurdity of the construction contended for by respondent may be simply illustrated. Let us assume that the gift to Mary H. Wilson was made four years earlier, on February 6, 1913. Let us further assume that there has been many earlier gifts of the same property, and that the last preceding owner who had paid a full consideration had purchased it in 1800 for $10.00, and that the petitioner sells it in 1942 for $300,000.00. Can the Commissioner ignore the value of the property on February 6, 1913, or March 1, 1913 in measuring taxable income? Under the construction which respondent urges he would be required to find a taxable gain of $299,990.00.

Such a construction is directly opposed to the intent of the words used, the purpose of Congress in enacting the amendment, and the meaning of the word "income". If the statute means what respondent contends it to mean, it is so capricious, illogical, retroactive and unreasonable that it is violative of the Fifth and Sixteenth Amendments to the Constitution.

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4. THE BOARD ERRED IN DETERMINING THAT PETITIONER WAS AVAILED OF IN THE TAXABLE YEARS FOR THE PURPOSE OF PREVENTING IMPOSITION OF SURTAX UPON ITS SHAREHOLDERS THROUGH THE MEDIUM OF PERMITTING ITS GAINS AND PROFITS TO ACCUMULATE INSTEAD OF BEING DIVIDED OR DISTRIBUTED.

No evidence exists in support of the Board's opinion on this issue. All of the evidence supports the business reasons for the failure to pay dividends. Incontrovertible evidence supports the disbelieved positive testimony that the purpose was not to avoid tax on the shareholders. No reason exists for the disbelief of the testimony. The Board's opinion on this issue is arbitrary and irrational.

The Board's decision relates to sections 104(a) of the Revenue Acts of 1932 and 102(a) of the Revenue Act of 1934 which read respectively as follows:

> "SEC. 104. ACCUMULATION OF SURPLUS TO EVADE SURTAXES.
>
> (a) If any corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders through the medium of permitting its gains and profits to accumulate instead of being divided or distributed, there shall be

levied, collected, and paid for each taxable year upon the net income of such corporation a tax equal to 50 per centum of the amount thereof, which shall be in addition to the tax imposed by section 13 and shall be computed, collected and paid upon the same basis and in the same manner and subject to the same provisions of law, including penalties, as that tax."

"SEC. 102. SURTAX ON CORPORATIONS IMPROPERLY ACCUMULATING SURPLUS.

(a) *Imposition of Tax.* There shall be levied, collected, and paid for each taxable year upon the adjusted net income of every corporation (other than a personal holding the company as defined in section 351) if such corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders or the shareholders of any other corporation, through the medium of permitting its gains and profits to accumulate instead of being divided or distributed, a surtax equal to the sum of the following:

(a) 25 per centum of the amount of the adjusted net income not in excess of $100,000. plus

(b) 35 per centum of the amount of the adjusted net income in excess of $100,000."

While the two sections above quoted differ in their wording, their purpose is the same.

The Board determined "that the corporation" (petitioner) "was not FORMED for the purpose interdicted by the above sections". (R. 60.) Therefore the issue before the Court is on the alternative: "Was the corporation AVAILED OF during 1932, 1933 and

1934 for the purpose of preventing imposition of surtax upon its two stockholders through the medium of permitting its gains and profits to accumulate instead of being divided or distributed?" (R. 61.)

Before discussing the "purpose" of the corporation and the findings of the Board in relation thereto, we desire to call the attention of the Court to the very peculiar arrangement of the report or memorandum decision so that findings are isolated under discussion and determination of certain issues and eliminated where they may be material to the consideration and determination of other issues, such as the one being discussed. This feature constitutes grievous error and, except by condoning the commission of such error, the Board cannot be sustained in its determination that petitioner is liable for surtaxes.

After making general findings as to the formation of a copartnership by F. A. Wilson and W. T. Wilson under the name of Wilson Bros. & Co. on January 31, 1927, and the organization of a corporation under the same name by the two partners on December 14, 1928, the report or memorandum opinion, after stating that certain issues had been settled by stipulation, declares:

> "The other issues will be considered in the order above set forth, *the facts,* except the general facts as to incorporation stated above, *being set forth separately* in connection *with discussion of each issue.*" (R. 33.) (Italics supplied.)

Thus no matter how material a finding of fact may be, it is not to be considered, says the Board, in the

determination of any other issue, unless re-found as applicable to such other issue. A declaration such as this, if sustained, means that a Board or Court can use or exclude testimony and evidence to suit its own purposes or that the petitioner or plaintiff must anticipate what the Board or Court may deem the issues and re-offer his testimony and evidence as being applicable in part or in whole to each of the several and specific issues involved. Such a situation is inconceivable, particularly in tax proceedings where the Commissioner's determinations are presumed to be *prima facie* correct and the burden of proof is placed on the taxpayer.

The findings made by the Board "as material" to the present issue are insufficient, omit important facts, and engage in error. Therefore, we will restate the material facts to accord with the several material findings made by the Board and the uncontradicted evidence applicable to all issues.

Petitioner was organized on December 14, 1928, by F. A. Wilson and W. T. Wilson to continue the business of the partnership. (General Finding, R. 33.) A partnership which was not engaged in logging or manufacturing lumber and owned no ships. (Special findings in issues II and III, R. 36, 43, 45.) Petitioner was organized to engage in the business of logging, manufacture, purchase, sale and transportation of lumber, and operation of steamships. (Special finding on issue V, R. 55.) The two stockholders had been continuously and actively engaged in the lumber business since 1906 (R. 88) and organized the cor-

poration to engage in a much enlarged endeavor. The steamers "Oregon" and "Idaho" were acquired in January, 1929, were operated by the petitioner for about six months and were then laid up, and had not again been put into operation at the close of the taxable years. (Special finding on issue V, R. 56.) The steamers were acquired by petitioner in January, 1929 principally for the purpose of transporting lumber. After acquisition they were operated only five or six months before they were "laid up" because business got so bad that they could not be operated at a profit. *The country then was experiencing a depression which lasted several years.* During the taxable years in issue the steamers were kept in serviceable condition, in order that petitioner might use them if opportunity was afforded to profitably resume lumber transportations. Petitioner *always expected* to put the ships back into commission and re-engage in the shipping of lumber *when conditions became favorable* and the vessels, though not actively in use, were considered a part of the operating assets of the petitioner. (Special finding on issue II wherein deductions for maintenance of the steamships were sustained. R. 35 and 36.)

During the taxable years involved some lumber and allied business was carried on. The corporation *always had the purpose* of re-engaging in the lumber and shipping business, but did not re-enter the logging, lumbering and milling business during the taxable years, *which would have required a capital of about $1,500,000.00,* because losses were then heavy in the logging and sawmill business, business *was de-*

pressed, no building was going on, it was hard to sell lumber, and it would have been unprofitable to go into a business which then was losing money. (Special findings on issue V, R. 56.) The record shows that approximately $1,500,000.00 or more would be required to re-enter the logging, lumbering and milling business (R. 101) and petitioner did not have this amount in cash or securities in any of the taxable years. (R. 58.)

After the formation of the corporation and during the years 1929, 1930 and 1931, in addition to the original assets set up on the books at a value of $696,000.00, capital cash contributions were made to petitioner by its two stockholders in equal amounts in total as follows: during 1929, $50,000.00; during 1930, $54,000.00; and during 1931, $480,312.24. During the taxable years, no capital contributions were made. (Statement of evidence, R. 109.) With such contributions of cash the petitioner purchased securities, in practically all cases stocks of domestic corporations. No stocks or bonds were transferred by the stockholders to petitioner. (Special findings on issue V, R. 57.) The Board found (Special findings on issue V, R. 61) that contributions by the stockholders included "large amounts of cash" made during the taxable years involved. The contributions of the stockholders were principally made prior to 1932 (R. 109) and the record contains no evidence of any other contributions than those pointed out above.

The securities acquired from all sources, as shown by the books of account and record, had a cost and market value for the taxable years as follows:

December 31, 1932	Cost	$750,943.50	Market value		$439,961.87
December 31, 1933	"	782,190.55	"	"	777,792.00
December 31, 1934	"	837,778.05	"	"	810,797.75

(Special findings on issue V, R. 58.) The securities *were acquired and held* by the petitioner *in order to have liquid assets* for the time when it would go back into the lumber, logging and milling business. They could be sold quickly and provide cash with which to buy anything petitioner wanted. (Statement of evidence, R.102.) At no time did the security investments plus cash on hand equal the $1,500,000.00 required for the proposed enlargement of the business. (R. 58.)

The total cash contributions to capital during 1929, 1930, and 1931 as stated above was $584,312.24. (R. 109.) As respondent's exhibits A, B and C show that for 1929 petitioner had net taxable income of $56.72; for 1930, a loss of $22,894.68 and for 1931, a net taxable income of $6305.00 (R. 180, 186, 190.) most of the cost of securities in excess of the $584,312.24 shown above was paid by the original cash capital of petitioner rather than from any accumulation of earned surplus. During all the taxable years involved the market value of the securities held was less than cost by considerable amounts. (Supra.)

During the taxable years no dividends were paid and no salaries were paid the officers of petitioner. (Special finding on issue V, R. 61.) Petitioner did not declare dividends during the taxable years involved because it was believed that the earnings were not sufficient to warrant dividends, an increase of assets was desired for future business purposes, and the

value of the assets was impaired. (Testimony, R. 101.) Such failure to declare dividends had very little effect upon the individual income taxes of the two stockholders. The failure to declare dividends did not result from any discussion between the stockholders of possible taxes falling upon either one of them individually. (Testimony, R. 102.) The findings on the income taxes payable by the two stockholders for the three taxable years involved would indicate that such a discussion was entirely pointless because W. T. Wilson paid only $150.00 income tax in 1932 and none in the years 1933 and 1934 while F. A. Wilson paid no tax in any of the years. (Special findings on issue V, R. 59.)

The Board's findings comment on the differences between the balance sheets shown on the income tax returns of petitioner for the three years involved and the balance sheets as they would have to be adjusted to accord with the books of account and the facts. (R. 57, 58 and 59.) These books of account were kept and the returns were made by one of the stockholders who confessedly was not a trained bookkeeper or accountant. (Statement of evidence, R. 89, 113.) While the stockholders of petitioner were satisfied with the system of accounting and could determine its financial status therefrom, nevertheless they readily assented to the employment of a highly reputable firm of certified public accountants to clarify their records of accounts and reconcile them with their income tax returns for the taxable years involved for the purposes of presenting petitioner's cause to the Bureau of Internal Revenue and the Board. (Statement of

evidence, R. 115.) It was petitioner, not respondent, who pointed out the defects in the returns and the books of account. (Statement of the evidence R. 88 *et seq.,* Exhibits 3, 4, 5, 6, 7, 8, 9, 10, 11, 18, 19, 20, 21, 22 and 23.) What was disclosed to the Board by petitioner was a primitive way of keeping accounts, which could be and was, analysed to show the real status of petitioner's affairs and an egotistical but tax harmless method of enlarging capital or surplus by personal I. O. U.'s which meant nothing to anybody but the stockholders.

In its report or memorandum opinion the Board accepts on the testimony introduced by petitioner, not by respondent, the adjustments on the books of account and returns. (Special findings on issue V, R. 57 et seq; Special findings on issue II, R. 35.) On the other hand it rejects certain items proven by the testimony and supported by exhibits admitted in evidence. Furthermore, in its endeavor to sustain the Commissioner on its issue V and thus determine petitioner liable for a surtax for accumulation of surplus, the report or memorandum opinion "assumes" as facts certain things which do not appear in evidence and which, if important, should have been inquired into on cross-examination by respondent. (R. 66.)

In order to present to the Court the essentials of petitioner's financial status for the years in dispute it is necessary to deal with its balance sheets.

Those balance sheets for the years in dispute, corrected to accord with the memorandum findings of fact and opinion of the Board, are as follows:

Assets:	1932	1933	1934	
Cash	$ 96,638.23	$ 9,186.43	$ 73,707.36	R. 58
Notes Receivable	14,000.00	—	—	R. 172
Call Loans	100,000.00	151,000.00	171,000.00	R. 171
Accounts Receivable, Trade	72,662.47	94,924.01	103,002.60	R. 37, 40, 176-178
Accounts Receivable, F. A. Wilson	—	43,234.37	35,612.50	R. 178, 179, 60
Accounts Receivable, W. Wilson	17,717.18	16,917.88	16,917.88	R. 60
Accounts Receivable, Mary H. Wilson	21,248.51	21,128.51	21,128.51	R. 173
Merchandise	—	6,500.00	3,946.60	R. 171
Bonds (cost)	13,425.00	13,445.00	30,245.00	R. 40, 170
Stocks	750,943.50	782,190.55	837,778.05	R. 58, 167-169
Land	30,000.00	30,000.00	30,000.00	R. 181
"Oregon", net after depreciation	90,126.99	83,869.35	77,251.71	R. 52
"Idaho", net after depreciation	48,968.89	45,471.11	41,943.33	R. 51
Furniture & Fixtures, net	1,782.18	1,584.16	1,386.14	R. 53
Autos, net after depreciation	2,436.84	1,263.18	524.52	R. 25
Total Assets	$1,259,950.49	$1,299,715.35	$1,449,972.20	
Liabilities:				
Accounts Payable	$ 3,064.68	$ 2,778.71	$ 3,246.39	R. 171
Capital	1,000.00	1,000.00	1,000.00	R. 57, 58
Earned Surplus (1931—$12,792.64)	19,426.64	47,875.92	86,838.71	R. 68, 231, 171, 71
Capital Surplus	1,236,459.17	1,248,060.72	1,358,789.10	
Total Liabilities	$1,259,950.49	$1,299,715.35	$1,449,972.20	

In the foregoing balance sheet assets and earned surplus are inclusive of the amount of bad debt deductions claimed by petitioner but disallowed by the Board. Similarly, depreciable assets appear at the figures determined by the Board. If petitioner's contentions are sustained, some fairly substantial adjustments will be required for:

Accounts receivable	(Woodhead, "Svea")
Bonds	(Kentucky Fuel Gas)
"Idaho"	(Basis and depreciation)
Earned Surplus	(Partial bad debts, Svea Account, additional depreciation, income tax liability accrued)

Some adjustment will also be required for "capital surplus".

The actualities of earned surplus accumulations are of the greatest significance, because without considerable accumulations no purpose to avoid surtax can be found. The petitioner's earned surplus as found by the Board and the adjustments thereto contended for by petitioner for the purpose of determining petitioner's accumulations are as follows:

	1931	1932	1933	1934
Surplus per B. T. A.	$12,792.64	$19,426.64	$47,875.92	$86,838.71
Woodhead, partial bad debt				5,000.00
Kentucky Fuel Gas, do.				5,500.00
"Svea"—expenditures not an asset	6,420.36	9,081.78	10,804.01	12,861.01
Add'l depr. Idaho		2,600.00	5,200.00	7,800.00
Surplus adjusted	$ 6,372.28	$ 7,744.86	$31,871.91	$55,677.70

Any corporate director of ordinary intelligence, in determining the amount of earned surplus available for distribution as dividends would consider carefully the market value of the more important assets. The charges made against the Woodhead Lumber Co. of California and the Kentucky Fuel Gas Bond accounts in 1934 were actually insufficient to reduce those accounts to their true worth. An expert witness, testifying for petitioner, stated that irrespective of the deductibility of the charge off on the Kentucky Fuel Gas Bonds, their asset value should be written down by at least $5500.00 for purposes of corporate financial statements. (R. 128.)

Certainly the same observation is true of the $42,000.00 account receivable of the Woodhead Lumber Co. of California, a corporation out of business and with assets of a maximum value of $25,000.00. By the end of 1934 this account should have appeared at not more than such maximum, with a further reduction in earned surplus of more than $12,000.00.

The "account receivable" resulting from the petitioner's expenditures for maintenance of the "Svea", as managing, disbursing, and collecting agent, was never an asset. The Board, in discussing the deductibility of the write offs against this account finds only a moral obligation to repay petitioner for these expenditures, and that petitioner was not a creditor as to them. (R. 39, 40.)

The Board committed grevious error in considering these accounts only with respect to the deductibility of the charges made against them, and in failing to

consider them with respect to the question of petitioner's accumulation of surplus. In fact, the Board wholly failed to determine in the memorandum findings of fact and opinion what surplus petitioner had accumulated!

In addition to the reductions of earned surplus hereinabove discussed, further reduction should be made for other impaired assets. The steamers "Oregon" and "Idaho", while having a very substantial cost basis, had not been in operation for several years because they could not be operated at a profit. (R. 35, 36.) During the years in question they necessitated large expenditures for maintenance and repairs. If petitioner could not profitably operate those steamers in its own business, their value to anyone would be very speculative and very small.

Thus, in realistic sense, petitioner, during the years in question, never had or accumulated any earned surplus whatever.

The respondent's determination on this issue for 1934 is in the following language:

> "An examination of the balance sheets submitted with the return leads the Bureau to conclude that your corporation is an investment corporation and subject to the provisions of Section 102 of the Revenue Act of 1934." (R. 18.)

In the deficiency notice for 1932 and 1933 respondent stated: "after careful consideration of your Federal income tax returns and of all other available evidence the Bureau holds that your corporation is subject to taxation under the provisions of Section

104 of the Revenue Act of 1932 for the years 1932 and 1933."

The balance sheets upon which respondent's determination was based were erroneous, principally in their treatment of shareholders' I. O. U.'s as being the equivalent of cash. No specific reason is stated for respondent's determination for 1932 and 1933, but apparently after examining the balance sheets contained in the returns he concluded, as he did for 1934, that petitioner was a mere holding or investment corporation.

While petitioner had large investments, it was not an investment corporation. It was organized for a particular purpose, i.e., logging, manufacture of lumber, and the purchase, sale, and transportation of lumber and the operation of steamships. (R. 56.) While the realization of that purpose was delayed by a worldwide depression, every act and omission of petitioner is consistent with that purpose.

A very large capital would be required. Petitioner's two shareholders undertook to supply it by equal contributions and by the preservation of the corporate assets. Their failure to declare dividends or pay salaries to themselves, particularly in the face of the impairment in value of many of the corporate assets is consistent with that purpose. The corrected balance sheets show some capital contributions during the taxable years. Apparently the respondent and the Board would require petitioner to declare and pay dividends to the shareholders at the same time they were making capital contributions to petitioner for its business purposes.

Both the respondent and the Board ignored the business purpose of the petitioner. The Board determined that petitioner was FORMED for that business purpose. (R. 60.) It then holds that was AVAILED OF for the prohibited purpose of avoiding surtax on its shareholders. The Board does not find that the purpose for which petitioner was organized was ever abandoned; it could not so find in the face of the positive and uncontradicted evidence to the contrary. (R. 101.) The fulfilment of that purpose was postponed for business reasons—the fact that lumber and shipping concerns were operating at a loss—but it was never abandoned. (R. 101-102.)

In discussing and allowing petitioner's expenditures for the maintenance of the "Idaho" and the "Svea" the Board said (R. 35, 36):

> "The steamers were acquired by petitioner in January, 1929 principally for the purpose of transporting lumber. After acquisition they were operated only five or six months before they were 'laid up', because business got so bad that they could not be operated at a profit. The country was then experiencing a depression which lasted several years. During the taxable years the steamers were kept in a seaworthy condition, in order that petitioner might use them if opportunity was afforded to profitably resume lumber transportation. The ships were never abandoned, but were always in charge of some one to look after them. The ships were put in dry dock and their bottoms were painted to protect and preserve them. Watchmen were employed and paid to look after them and certain supplies were furnished. Repairs were made to maintain the ships in proper

> serviceable condition. Petitioner always expected to put the ships back into commission and re-engage in the shipping of lumber when conditions became favorable * * *''

These same facts are most material to the surtax issue but receive but little mention by the Board in its finding and opinion relating thereto. The Board does find that the corporation "always had the purpose of engaging in the lumber and shipping business", that the partnership's capital in such business had been $1,500,000.00 and that at the date of the hearing at least as large an amount would be required. (R. 56, 63.)

In sustaining the respondent on this issue the Board's opinion may be said to consist of the following arguments:

(1) "Because the testimony of the capital required by petitioner for full and complete logging, lumber manufacturing, and shipping business did not relate specifically to the taxable years, no business reason was shown for the accumulation of its comparatively small surplus." (R. 63, 64.)

(2) "The positive and uncontradicted testimony of W. T. Wilson would defeat the imposition of the tax if believed. It is discredited, however, by the false balance sheets annexed to the returns, which returns were over the oath of the same witness." (R. 62, 63, 66.)

(3) "The corporation did but little business during the taxable years, and did not re-engage in logging, lumber manufacturing, and shipping because those

businesses were losing money—these statements almost put petitioner out of business." (R. 64.)

(4) "F. A. Wilson and W. Wilson (whom we can assume to be W. T. Wilson) were permitted to owe petitioner on accounts receivable. They therefore treated petitioner pretty much as they pleased." (R. 65, 66.)

(5) "The two shareholders of petitioner paid no income tax during the years in question, except for about $150.00 paid by W. T. Wilson for 1932. Hence they gained a substantial tax advantage by petitioner's failure to pay dividends." (R. 59, 66.)

The foregoing points made by the Board will be discussed in the order in which they appear above.

(1) The Board's argument with respect to the absence of proof of a reasonable business need for the accumulation of petitioner's small earned surplus is self-defeative. While it is true that petitioner's actual business was small and required little capital, its contemplated operations were extensive and would require a great deal. The actual amount required could not possibly be accurately known in 1932, 1933 and 1934 because the petitioner did not, in each of those years, contemplate immediate enlargement of its business.

Petitioner contemplated the enlargement of its business as soon as a reasonable demonstration of probable profits indicated it could profitably do so. Naturally the culmination of that purpose would be postponed for as long as other logging, lumber manufacturing and shipping concerns were losing money. Petitioner's

business purpose would be defeated if its assets were invested in a losing enterprise. It was promoted by investments in liquid income-paying assets. While petitioner could unquestionably purchase timberlands for less when those lands could not be profitably logged, it naturally preferred to wait and pay more later when it had a reasonable assurance of profits.

Evidence of the cost of full scale operations during the taxable years in question is absolutely immaterial to the issue. They were all depression years and while timberland *speculation* during them might be justified, *business investment* could not.

The business need for the accumulation was the greater because of these facts. Petitioner could not and did not know how much ready capital it would need as conditions improved and prices rose. It wanted to have enough to meet that need, whatever it might be. Therefore, it paid neither salaries nor dividends to its officer-shareholders.

The Board's argument is interesting on this phase of the issue. As heretofore stated, it would take a prescience beyond that of petitioner's officers to accurately estimate its cash (or equivalent) needs. Yet the Board of Tax Appeals can say "you have more than you need (needed); our judgment is superior to yours when it comes to an estimate of your needs".

The Board's determination on this phase of the issue is directly contrary to two cases in which it was held that the prospective needs of the future contemplated enlarged activities were the governing consideration. As long as the intention to enlarge opera-

tions continued to be the reason for accumulation of surplus, the surtax asserted was improper.

William C. De Mille Productions, Inc., 30 B. T. A. 827, 830;

Cecil B. De Mille, et al., 31 B. T. A. 1161, 1175, aff'd 90 F. (2d) 14.

The facts in the last cited case are similar but much less favorable to the taxpayer. The taxpayer's income was from contracts for personal services, its surplus as high as $1,606,575.33.

(2) Admittedly the balance sheets were inaccurate from the standpoint of an expert accountant. W. T. Wilson was not an expert accountant and made errors inconceivable to an expert. The greatest errors were in treating the I.O.U.'s of himself and his brother as the equivalent of cash and in treating capital surplus as capital. The other errors followed almost inevitably from these two, with the further factor that the two brothers were the sole shareholders, officers and directors of petitioner and understandably omitted formal corporate procedure. Thus when they agreed that the corporation should have treasury stock, they failed to actually transfer shares to it. As far as they were concerned, they understood the act as the same as if actually accomplished. No one was injured by this procedure. There were virtually no creditors. The Federal Government was not prejudiced in any way. The gross income of the corporation was correctly stated, and except for the disputable items of partial bad debts and depreciation allowance, so were the deductions.

Regardless of how inexcusable are the errors in the balance sheets, they illustrate no desire to defeat or defraud either the Federal Government or anyone else. It has been shown (*supra*) that it was the petitioner who undertook to supply the respondent and the Board with accurate balance sheets. The only effect of the errors contained in the returned balance sheets was to lead respondent to believe that a surtax was due (R. 18, 222), and therefore make a determination which otherwise would probably not have been made.

These facts do not excuse the Board in treating the direct, positive, and otherwise unchallenged testimony of W. T. Wilson as the equivalent of perjury, or believing it in part and discarding it in the parts disadvantageous to the conclusions sought to be reached.

(3) While petitioner's active business transactions were limited and not particularly profitable, it must be remembered that the years in question were the years of severest depression. Petitioner was doing the best it could and all it could to maintain a going business in the face of adverse circumstances. The Court will take judicial notice that like conditions existed with like and other lines of business throughout the country.

The Board member was obviously guilty of an error of law when he considered the surplus accumulations in the light of actual business operations rather than in the light of contemplated business operations and needs. *Cecil B. De Mille, et al., supra.*

The member's conclusion that the witness' statements almost put the petitioner out of business is

hardly worthy of comment. The witness testified that logging, lumber manufacturing, and shipping businesses were losing money during the years 1932-1934, and that, therefore, petitioner did not engage in any of those enterprises. (R. 64.) This testimony related to petitioner's delay in fulfilling its business purpose to the complete limit of that purpose. It had nothing to do with petitioner's wholesale lumber business.

Petitioner's lumber business was increasing during the years in question, as shown in the following table:

	1929	1930	1931	1932	1933	1934
Sales	$353,833.46	$139,196.14	$64,571.55	$28,725.96	$92,862.09	$170,239.51
Gross Profit on sales	47,757.63 (R. 180)	11,914.14 (R. 186)	(5,151.15) (R. 190)	(4,629.77) (R. 132)	8,424.60 (R. 142)	20,152.56 (R. 153)

The Board member in stating that petitioner had no immediate need in 1932-1934 for the small surplus accumulated may be even logical from the viewpoint of 1940, when he considered the proceedings. How immediate the need *seemed* to petitioner's officers at any time during 1932, 1933 and 1934 is another question. And of course, because the surtax can be found only where the intent was to accumulate, not for business reasons, but for avoidance of tax by the shareholders, our inquiry must be to things as they seemed.

Petitioner's business in 1933 was better than it had been in 1932. It was better yet in 1934. With this improvement naturally the time for full-fledged operations in accordance with petitioner's purpose seemed more imminent.

The Board apparently considered the smallness of business done by petitioner and the absence of large profits therefrom to have been the result of deliberate self-sabotage. It apparently chose to ignore the self-interest of petitioner in making profits, and also, at this point, the universally known facts concerning the depression.

(4) The Board seemed to place great emphasis and reliance on the fact that F. A. Wilson and W. Wilson (assumed by the Board, without a shred of evidence to support its conclusion, to be W. T. Wilson) were permitted to owe the petitioner on accounts receivable. From this fact and assumption it concluded that the shareholders treated petitioner pretty much as they saw fit. (R. 65.)

The record proves the contrary. In the first place, these accounts receivable were being reduced at the same time each of petitioner's shareholders were making contributions to petitioner's capital! They were not borrowing sums from the corporation.

In the second place, the detailed analysis of the account of F. A. Wilson discloses the account to be the result of stock brokerage transactions undertaken by him for the benefit of the corporation, in reality a trust relationship rather than a debtor-creditor relationship. This account was closed by petitioner's payment to F. A. Wilson of $37,366.25 in December of 1934 and his delivery to petitioner of Kennecott Copper Co. and other shares costing $35,612.50 on January 2, 1935. He wasn't dealing with the corporation, he was acting for it. (R. 178, 179.)

In the third place, upon what basis does the Board assume "W. Wilson" to be W. T. Wilson? There is no evidence or testimony upon which such an assumption could properly be made.

The Board felt that the picture of the accounts receivable was similar to that presented in *Rands, Inc.,* 34 B. T. A. 1094. (R. 66.) Petitioner fails to see the similarity.

In the *Rands* case, *supra,* the corporation was organized by the principal shareholder with the conveyance to it of $1,502,273.17 in stocks and bonds. It was formed as a speculative medium for dealing in stocks, bonds and real estate. One shareholder held over 99 per cent of the stock of the tax payer and alone guided its policy. The tax payer's principal activities consisted of *trading* in common stocks of a speculative nature, amounting to between 100 and 160 transactions per day. The principal shareholder *lent* sums running to nearly $2,000,000.00 to the tax payer for stock speculations. His remaining assets consisted largely of tax exempt bonds. The tax deficiencies involved (principally the 50% surtax) amounted to $315,306.91 for 1927, $475,025.87 for 1928, $239,051.62 for 1929, and $28,614.83 for 1930, indicating average earnings of more than $500,000.00 per year, none of which were distributed.

On the other hand, this petitioner was formed for a business purpose and this purpose was never abandoned. The years in question were depression rather than "boom" years. Petitioner's two shareholders lent none of their funds to petitioner. It does not

appear that any of their holdings were tax exempt and because of respondent's failure to offer evidence on that point we may safely assume they were not tax exempt. If petitioner had currently distributed all of its very small earnings each year little or no tax would have had to be paid by the shareholders. Petitioner's earnings never exceeded 3 per cent of its capital. The annual earnings of Rands, Inc. amounted to as much as 50 per cent of its capital. Petitioner's shareholders had no transactions with it during the years in question; Rand's principal shareholder had many.

Where is the similarity? There is none whatever. *Rand's Inc., supra,* rather than supporting the Board, indicates the arbitrariness and unreasonableness of the Board's opinion on this issue.

Furthermore, in the *Rand's* case, *supra,* and in all other cases in which the imposition of the surtax has been sustained, no business purpose was shown for the acquisition of stocks and bonds. Here the business purpose was shown and was found to exist during the taxable years. The Board accedes to the purpose but substitutes its own judgment as to the reasonableness of the need.

The contributions of petition's shareholders to it were of cash rather than of stocks and bonds. There is therefore no implication in the record that if petitioner had never been created their income would be any greater than it was after petitioner's creation. The larger transfers to petitioner, at least, were of cash lying idle in bank, and were not the result of

sales by the shareholders. (R. 90, 109.) Can it be assumed that in the absence of the transfers to petitioner its shareholders would have invested this cash? They had not done so prior to the transfers.

(5) The Board apparently felt that the fact petitioner's shareholders (with the single exception of W. T. Wilson for 1932) paid no income tax whatever was proof that petitioner was availed of for the prohibited purposes. Petitioner believes that this fact is positive and incontrovertible proof of the contrary. Unless tax was in fact avoided, the prohibited intention cannot be found.

It is significant that the originals of the returns of petitioner's shareholders were in respondent's possession, but were not placed in evidence in this proceeding. It may well be that those returns would show, with the single exception above noted, that if *all* the earnings of petitioner had been currently distributed, no increase in tax would have resulted.

Even in the absence of its business purpose it would not be reasonable to require petitioner to distribute the last cent of its annual earnings and profits. Some of petitioner's assets and particularly the steamships, the Kentucky Fuel Gas Bonds, the accounts receivable from Woodhead, and the account represented by expenditures on the Svea, were of a value far less than that carried on the books. If these items had been written down to their true worth, petitioner would have no earned surplus to distribute in any of the tax years involved, which same years presented a very doubtful and uncertain picture for the future.

The net earnings of petitioner for the year 1932 were less than $7000.00, as found by the Board. And the Board found that as to the $6420.36 item of Svea advances, petitioner was not a creditor; it was only a moral obligation. (R. 38, 39.)

The taxes determined in this proceeding are $3316.84 for 1932, $11,652.75 for 1933, and $15,724.73 for 1934. The original deficiencies asserted were much larger. (R. 69, 31.)

Even assuming that the entire earnings for 1932 as found by the Board were distributed pro-rata to the shareholders, each would have to report a dividend of $3317.00. F. A. Wilson's tax on this might be nothing and *could not possibly exceed $33.17.* W. T. Wilson's additional tax *could not possibly exceed $375.36.* These figures assume the respective shareholders to have other net income subject to surtax (and in excess of their allowable credits) of $6000.00 and $18,250.00, respectively.

Revenue Act of 1932, Section 12(a).

If petitioner had distributed *all* of its earnings for 1933 as found by the Board ($28,449.28), *the maximum possible tax liability* of each would have been $479.94 on a surtax net income of $20,449.28.

Revenue Act of 1933, Section 12(a).

If petitioner had distributed *all* of its earnings for 1934 as found by the Board ($38,962.79) *the maximum possible tax liability* of each would have been $1813.83 on a surtax net income of $23,481.40.

Revenue Act of 1934, Section 12(b).

All the figures above-given of possible maximum tax liability assume sufficient other income to exhaust all deductions, exemptions and credits and yet leave surtax net income up to the point of commencement of surtax liability.

It would be just as reasonable to assume, during these depression years, that the shareholders had bad debts and other deductions which would eliminate any additional tax from complete distribution of petitioner's earnings.

The Board's determination, as hereinbefore stated, was not based upon any adjusted figures of petitioner's earned surplus. It was apparently based, as was the Commissioner's determination, upon the figures set forth in the deficiency notice. (R. 55.) A comparison of these figures with those as corrected to accord with the Board's opinion will show that the essential premise of accumulations of surplus was greatly exaggerated.

	1932	1933	1934
Annual Earnings per respondent	$21,731.50	$38,415.51	$44,071.25 (R. 55)
As corrected for decision	6,634.00	28,449.28	38,962.79
Difference	$15,097.50	$ 9,966.23	$ 5,108.46

The respondent's determination was clearly predicated on errors, and the Board never took these errors into consideration. Petitioner believes that in the argument on the preceding issues additional errors have been established, the effect of which is to further destroy one of the essentials which must exist

in order for petitioner to be held liable for the surtax. The effect of these errors must be taken into consideration, and if necessary, the case should be remanded to the Board to consider their effect.

It is one thing for the Commissioner and Board to say the accumulation of $22,000.00. of earnings in 1932 exhibits the prohibited purpose. That is bad enough. But it is far worse when the determination based upon $22,000.00 is sustained without discussion or consideration that the $22,000.00 never existed and was an exaggeration of 300 per cent!

The Board should have determined, *prior to making its determination on this surtax issue,* just exactly what petitioner's accumulations were. It should then have determined how much of those small accumulations, if any, were available for and should have been distributed currently as dividends. It should finally have considered the effect upon the shareholders' tax liability of the distribution of such dividends.

The Board actually did none of these things. If it had done them it would have discovered that little or no tax liability was saved petitioner's shareholders. It would then have been forced to believe W. T. Wilson when he testified that dividends were not declared because the assets were impaired; because a large liquid capital was desired with which to engage, as had a predecessor partnership with a capital of $1,500,000.00, invested in logging, timber lands and lumber mills, and engaged in operating steamers. It would have been forced to believe that witness

when he testified that the failure to pay dividends was not the result of any discussion between the shareholders of possible taxes on either of them. (R. 101-103.)

The foregoing testimony was positive and unequivocal. It was not made the subject of any cross-examination nor contradicted by any other evidence. It is a part and parcel of all of the evidence and is in accord with it, and was disbelieved solely because petitioner's balance sheets contained errors immaterial to any issue in this or any other proceeding. It is directly supported by the evidence and findings of petitioner's business purpose, the transfers made to petitioner every year pursuant to that purpose, and the absence of any material increase in the shareholders' tax liability had petitioner never been created or had petitioner currently distributed all its earnings.

Petitioner submits that the surtax liability determined against it was improper and is not supported by any evidence. The Commissioner erroneously determined an excessive amount of earnings for each year. The Board failed to correct the Commissioner's errors. Certain amounts of petitioner's earnings are still in dispute. It had a legitimate business reason for accumulating all the liquid assets it could acquire and its shareholders, by transfers to capital surplus, were aiding that purpose. It was not, as erroneously found by the Board, being dealt with by its shareholders as they pleased. Neither of them borrowed from nor loaned to it in the taxable years. F. A. Wilson dealt for petitioner as a stock broker, and not with

it. Because of small earnings, impaired assets, and its business purpose petitioner paid no dividends. Its failure to pay dividends was not because of any discussion between or purpose of its shareholders to avoid tax on their individual incomes. Little, if any, additional tax would have been paid by those shareholders if the petitioner had currently distributed all of its income as found by the Board. The Board's determination of income was excessive. Petitioner had no net earnings available for dividends.

Petitioner submits that on this issue the Board of Tax Appeals should be reversed. At the very least, and in fairness to petitioner, the cause should be remanded to the Board to reconsider this issue in the light of petitioner's earnings of each year as corrected by this Court, its earnings available for dividends, and the effect of the payment of dividends on both the corporation, in the light of its business purpose, and upon the shareholders, in the light of their individual tax liability for the years in question.

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5. **THE BOARD ERRED IN FINDING AND DETERMINING FOR EACH OF THE TAXABLE YEARS INVOLVED THAT PETITIONER WAS LIABLE FOR A FIVE PER CENTUM NEGLIGENCE PENALTY.**

In his deficiency notices upon which the two proceedings were initiated before the Board of Tax Appeals the Commissioner states as his reason for the determination of the negligence penalty for each of the taxable years involved as follows:

> "The understatement of tax * * * is attributable to negligence." (R. 19, 224.)

This statement contains the only issue petitioner was required to meet and the only ground upon which the Board can have jurisdiction, to determine a negligence penalty under such deficiency notices. Had there been an intentional disregard of rules and regulations the Board could not consider it, because the Commissioner did not determine the alternative ground provided in section 293(a), *post,* as a basis for the penalty, nor plead it in his answers. For anything beyond his assertions in the deficiency notices the burden was on the Commissioner to plead and prove. As to facts, we again have an example of the Board's isolation of specific findings from general findings. The Board makes no findings in this issue VI, but states: "The facts above set forth and reviewed in discussion of section 104" (Issue V in the report or memorandum opinion and part 4 of this brief) "are here applicable with equal force." The purpose and terms of section 104 are so far apart from the provisions of the statute here to be considered that we cannot conceive how the Board could for one moment consider the facts under one statutory provision to be "applicable with equal force" to an entirely different provision. Moreover, the facts on issue V do not apply to issue VI.

To clarify this assertion, we quote the material part of section 293 of the Revenue Act of 1932, which is identical in language with section 293 of the Revenue Act of 1934, viz:

> "SEC. 293. ADDITIONS TO THE TAX IN CASE OF DEFICIENCY.

(a) *Negligence.* If any part of any deficiency is due to negligence, or intentional disregard of rules and regulations but without intent to defraud, 5 per centum of the total amount of the deficiency (in addition to such deficiency) shall be assessed, collected, and paid in the same manner as if it were a deficiency * * *''

(N. B.) By its punctuation the above section clearly makes ''negligence'' something apart from ''intentional disregard of rules and regulations.'')

The Commissioner in his application of the above quoted section asserted that the penalty for each year was added to the deficiency because ''the understatement of tax'' * * * ''is attributable to negligence'' (R. 19, 224.) but he did not refer to ''rules and regulations'' nor define what acts or omissions constituted the negligence upon which he imposed the penalty by any explanation in the deficiency notices; nor did he plead affirmative allegations in his answers which enlarged the reasons set forth in the deficiency notices or in any way referred to ''disregard of rules and regulations.'' (R. 19, 227.) We are therefore left with but one cause for the assertion of the penalty, viz: the returns failed to report income or sought deductions which reasonable judgment did not warrant. No matter how poorly the books of account of petitioner may have been kept, and such fact seems to be the basis of the Board's decisions, let us look for ''the understatement of the tax'' in the returns which, as far as the record shows was, in the Commissioner's mind when he asserted negligence. The

section quoted above deals only with negligence in reporting income, not in keeping books and records.

(1) Gross Income as reported for normal tax in the returns for petitioner (Exhibits 3, 4, and 5) was: $32,565.57 for 1932; $75,579.28 for 1933; and $63,-901.60 for 1934. The only challenge the Commissioner made to gross income as returned was to add interest to that income for the years 1932 and 1933. These additions were disallowed by the Board in issue I of its report or memorandum opinion. (R. 33-35.) Certainly there was no negligence on the part of petitioner in reporting gross income.

(2) Deductions sought by petitioner in its returns for the three years involved constitute the main grounds for dispute between the parties in relation to the net taxable income for normal tax. (R. 32.)

(a) For maintenance of steamships petitioner's returns claimed $4547.05 for 1932; $4412.26 for 1933; and $2173.18 for 1934. The Commissioner allowed the deduction for 1934 and the Board sustained petitioner's claims for 1932 and 1933 in issue II of its report or memorandum opinion. (R. 35-37.) Where was the negligence on this point?

(b) Partially bad debts written off consist of three items, viz.: on accounts receivable from Woodhead Lumber Co. of California in the amount of $5000.00 for 1934; accounts receivable from "S. S. Svea" in the amounts of $2160.80 for the year 1933 and $4644.40 for the year 1934; and accounts receivable on bonds of the Kentucky Fuel Gas Corporation

in the amount of $5500.00 for the year 1934. While the Board has determined adversely to the petitioner on these claimed deductions, it has not done so on the grounds of any negligence on the part of petitioner, excepting, perhaps, in failure of proof on hearing to which section 293, *supra,* would not apply. On the other hand petitioner has appealed to this Court from the Board's determinations of non-deductibility of the partial write-offs and deductions relating to the accounts of the Woodhead Lumber Co. of California and Kentucky Fuel Gas Corporation bonds under the firm belief that the determination of the Board was erroneous. As argued under Point No. 1 *supra,* the determination of a partial write-off is a matter of judgment and if this Court seeks to sustain the Board in disallowing these claimed deductions it cannot determine that an error in judgment is negligence. With regard to the deductions sought on the accounts receivable from the "S. S. Svea", while we do not appeal from the decision of the Board, it may be said that there were advised errors in judgment under circumstances which in no way may be attributed to negligence. The fact that the Board finds that the accounts receivable amounted to $9081.78 on January 1, 1933, and to $10,-804.01 on January 1, 1934; that there was a moral obligation on the petitioner to keep the vessel in repair, and that it was advised by an attorney that "it did not look like recovery could be made and a suit would be foolish" (R. 39) would naturally lead petitioner to seek partial deductions. If there was a failure of proof before the Board, as found (R. 40), such failure on hearing before the Board cannot constitute

negligence in making the returns and the Board in denying the deduction does not so find. (R. 38-40.)

(c) Depreciation constitutes the next items of deductions sought and, for each of the years, as per the returns, was as follows:

	1932	1933	1934
Wooden buildings	$1,000.00	$1,000.00	$ 500.00
Automobiles	900.00	1,649.85	1,649.85
S.S. Idaho and Oregon	8,750.00	8,750.00	8,750.00
Furniture and fixtures	500.00	500.00	500.00

The parties stipulated the depreciation allowances on the wooden buildings and automobiles before the proceeedings came before the Board. (R. 33.) Therefore, those items were not before the Board for consideration in any way and it was not called upon to pass judgement on the claims of petitioner or the adjustment with respondent in any way. With regard to the steamships we would point out that after the returns for the three years had been filed, the Commissioner extended the depreciable life of the vessels by fifteen years and changed the theretofore accepted rate of depreciation. (R. 46, 225.) He also decreased the residual value of the vessels which petitioner contested and, as to "S. S. Idaho", is contesting in these cases. These factors could not have been considered by petitioner in making its returns. However, on the determination of the amount of depreciation made by the Board and its decision made upon the computation of respondent, $9935.42, or $1185.42 in excess of the amount claimed by petitioner in its returns, was decided to be the amount which petitioner was entitled to deduct as depreciation on the two vessels. If there

was negligence here, it certainly was not such as should subject petitioner to a penalty. With regard to depreciation on furniture and fixtures the petitioner took the same deduction for 1929, 1930, and 1931 as it did for the three years involved and such deductions were allowed for the first three years by respondent. (R. 52.) Can it be said that petitioner was negligent in 1932, 1933 and 1934 for what the Commissioner allowed for the first three years of the petitioner's life? We do not think so. Long after the deductions of the first three years had been followed for the next three years (R. 220, 225) the Commissioner changed the cost basis and increased the depreciable life of the furniture and fixtures, thereby reducing the annual rate of depreciation. In contesting this action before the Board, the Commissioner's acts were approved, but on account of petitioner's failure to sustain the burden of proof of cost at the hearing and not on the ground of negligence in making the returns. (R. 53, 54.)

We have covered all of the items which affect the net income of petitioner for normal tax for the three years involved and can discover no "understatement of tax * * * attributable to negligence" as claimed by the Commissioner. The poor bookkeeping methods and the I. O. U.'s upon which the report or memorandum opinion dilates have nothing to do with the penalty for negligence which the Commissioner contemplates in his assertion of reasons for imposing one. When we compare the Commissioner's enlargement of income in his deficiency notices for normal tax purposes with petitioner's returned income for each of the years and

with the income determined by the Board, we find the greater error on his part. Was he negligent?

	1932	1933	1934
Normal tax returned by petitioner	None	None	None
Normal tax determined by Commissioner	$11,343.36	$22,078.01	$2,614.46
Normal tax determined by Board	None	1,499.93	1,912.05

We believe that these figures show that there were matters involving controversy between the parties but that, when the Commissioner so woefully fails to sustain his enlargement of the tax he cannot under the reasons alleged by him claim penalty against petitioner, and the Board erred in sustaining even a fragment of his asserted penalty.

(d) A penalty for negligence for failing to return a surtax is something difficult to comprehend, because a taxpayer who reasons that he should not dividend his surplus and forms his judgment and makes his return on that basis must deny his reasons and deem his judgment poor if he does return and pay surtax. The Board found and this Court may take judicial notice of the fact that during the taxable years the nation was in such a state of depression and economic panic that no one could tell what the morrow would bring. There was no negligence as far as the books of account or the returns are concerned in setting forth the items which might render petitioner liable for surtax. The income from all sources was accurately reported in the returns. We believe that we have shown in our argument on the immediately preceding issue that the surplus accumulated was not adequate to require a return for surtax. But, if this court should determine to the contrary, there is no negligence such

as the Commissioner contemplated to warrant the imposition of a five percentum penalty. More important is the fact that there is no place on a corporation return to report surtax, nor any provision in any law requiring the reporting of surtax liabilities.

We ask the Court to read the short opinion on issue VI (R. 67) to see what fallacious reasoning is used to determine the penalty. The negligence asserted by the Commissioner relates to "understatement of the tax", not to enlargement of cash through I. O. U.'s, erroneous treatment of capital stock, or maintaining no cash book. The things which the Commissioner claimed as a result of these things, with the exception of the surtax, were entirely demolished by the Board's findings and decision, as shown by the comparative tabulation above. Yet the Board says: "Obviously, a part of the deficiency was due to 'negligence or intentional disregard of rules and regulations' without which the tax in this case could have been ascertained without all the difficulty encountered". What "part of the deficiency was due to negligence" the Board does not find. "Obviously" the deficiencies were made more difficult to ascertain through the unwarranted acts of the Commissioner than they were by any acts of petitioner as is clearly disclosed by the tabulation of normal tax shown above. "Obviously", other than in the dogmatic statements contained in issue IV of the report or memorandum opinion, there is no finding that there was any negligence on the part of petitioner, and certainly no specific findings of fact upon which the opinion could be based. Incompetence or ignorance do not constitute negligence.

As we have pointed out, the adjustment of normal income which produced the deficiencies found by the Board resulted entirely from adjustments of deductions sought by petitioner in its returns. As we have shown in the foregoing argument there was reasonable ground for petitioner to claim all its deductions and to differ from the conclusions reached by the respondent. Under such circumstances no negligence penalty should be allowed.

Herman Senner v. Commissioner, 22 B. T. A. 655, 658; Acq. X-2 C. B. 64;

Frank T. Heffelfinger v. Commissioner, 32 B. T. A. 1232, 1234;

Davis Regulator Co. v. Commissioner, 36 B. T. A. 437, 444; Acq., 1937-2 C. B. 7.

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6. THE BOARD ERRED IN NOT MAKING ITS FINDINGS OF FACT COMPREHENSIVE AND GENERAL SO THAT, WHERE MATERIAL, THEY WOULD APPLY TO ALL ISSUES. IT FURTHER ERRED IN SEPARATING AND DIVIDING ITS FINDINGS UNDER SEPARATE ISSUES AND THUS MAKING FACTS APPLICABLE ONLY TO ONE ISSUE AND EXCLUDING SUCH FACTS FROM OTHER ISSUES TO WHICH THEY WERE MATERIAL. IT FURTHER ERRED IN INTERMINGLING FINDINGS OF FACT, CONCLUSIONS OF FACT AND CONCLUSIONS OF LAW SO AS TO RENDER PORTIONS OF ITS DECISIONS ARBITRARY AND ERRONEOUS IN FACT AND LAW. IT ALSO ERRED IN NOT MAKING ITS FINDINGS OF FACT AND CONCLUSIONS OF LAW CONFORM TO THE EVIDENCE.

Under this heading we have consolidated specifications of error numbered 19 to 24 in the Petitions for Review. (R. 78, 241.) In making these assignments of error, we appreciate that we are doing the unusual.

However, the report or memorandum opinion for the two cases is so unusual as to require special treatment and comment. In no reported case within the knowledge of the writers hereof has a Court or Board by specific direction excluded findings from consideration on all issues to which they might be material and confined their application to a single issue as the Board has done by its declaration:

> "The other issues will be considered in the order above set forth, the facts, except the general facts as to incorporation stated above, being set forth separately in connection with discussion of each issue." (R. 33.)

If facts are to be found issue by issue, then the facts should be found fully as to each issue. This the Board did not do.

This error is particularly noticeable in issue VI of the report or memorandum opinion where no facts applicable to the issue are found. Reference is made to the facts found in issue V, which make no reference to negligence nor any facts applicable to negligence.

As we have pointed out the strange results of the strange separation of findings of fact in our discussion of the prior assignments of error we will not extend this brief by reiteration. We believe we have shown that, by its isolation of facts in finding separately for different issues, the Board has violated the rules laid down for its observance by the Courts.

> "The Board of Tax Appeals, recognizing the fact that its rulings of law are reviewable, should make all reasonably requisite findings of fact."
>
> *Brampton Woolen Co. v. Commissioner,* (CCA 1), 45 Fed. (2d) 327.

VI. PRAYER FOR RELIEF.

WHEREFORE, petitioner prays this Court to hear the proceedings and to reverse the decisions of the United States Board of Tax Appeals on the issues hereinbefore presented, and for such other and further relief as to this Court may seem meet and proper.

Dated, San Francisco,
June 6, 1941.

ADOLPHUS E. GRAUPNER,
LOUIS JANIN,
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